SECURITIES REGULATION — A CASE FOR APPLYING THE PROXY RULES TO SOLICITATIONS FOR FUNDS IN CLASS ACTIONS BASED UPON THE SECURITIES ACTS

I. INTRODUCTION

A. *Statement of the Problem*

The objective of securities regulation is the protection of the public and the investor from unfair and negligent practices involving investment securities.[1] Since *Kardon*,[2] the achievement of this objective has been effected by private action as well as by the activities of the Securities and Exchange Commission. Moreover, the feasibility of private action in securities litigation has been increased by the greater utilization of the class action.[3] The authors acknowledge the vital role of private action in securities enforcement and the special import of the class action in realizing this role; however, the following hypothetical situation demonstrates the need for thoughtful consideration of the potential difficulties resulting from the interaction between existing securities regulation and the class action suit.

It is not difficult to imagine an investor who considers the hopeful undertaking of a new company and, based upon an examination of the prospectus, decides to invest in the company's new offering of registered securities. The company, taking the capital obtained through the sale of these securities, begins operations, but rapidly encounters difficulties and is soon near bankruptcy. The investor, realizing the mistake of his investment, searches for a way to salvage the investment and determines that the company's prospectus has misrepresented material facts. He then proceeds to circularize fellow security holders, advocating his position and seeking funds with which to prosecute a class action against the company. Defense of the suit further dissipates the company's assets and thus, at a minimum, reduces the liquidation value of the security to the security holders.[4]

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[1] This objective was characterized by the House Report on the Securities Acts Amendments of 1964 as, "to protect the public and investors against malpractices in the securities and financial markets." H. R. REP. NO. 1418, 88th Cong., 2d Sess., U.S. CODE CONG. AD. NEWS 3013, 3016 (1964).

[2] Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946).

[3] The class action suit is based upon Federal Rule 23. For applications of the rule to Securities actions see Dolgow v. Anderson, 43 F.R.D. 472 (E.D.N.Y. 1968); Green v. Wolf Corp., 406 F.2d 291 (2d Cir. 1968); 44 N. DAME LAW. 984 (1969).

[4] Typically the company would have indemnified its officers and directors who are the likely targets of this type of action. Such indemnification is largely a matter of state law and is generally allowed. *See, e.g.*, OHIO REV. CODE ANN. § 1701.13(E) (Page Supp. 1971). There is some question as to the validity of indemnification with regard to securities matters as being against federal public policy, but there is apparently no question as to the reimbursement of ex-

This brief hypothetical suggests the question to be discussed in this note: Is a letter soliciting funds for a war chest to finance a class action suit against a corporation a solicitation for a "consent" or an "authorization" under § 14(a) of the Securities Exchange Act of 1934[5] and therefore subject to the federal proxy rules?[6] Since there are no decisions in point, the conclusions reached are therefore not conclusions from authority, but result from an examination of the theories underlying prior judicial opinions and an expansive interpretation of the Congressional purpose embodied in the Securities Exchange Act of 1934.[7] The authors contend that the proxy rules should apply to such a solicitation, since the federal securities laws were passed to insure investor protection in all matters affecting security ownership. Application of the proxy rules in a case such as this contributes to investor protection by insuring adequate disclosure, continues the development of federal regulation consistent with the regulatory purpose, and aids the courts in achieving judicial economy and control in the prosecution of the class action.

B. *The Definitional Problem—The Act and Commission Rules*

Section 14(a) provides:

> It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to Section 78*l* of this title.

The theory that the purview of the proxy rules is sufficiently wide to include the solicitation of funds from security holders in a class action is based upon the literal language of the definitions contained in Rule 14a-1[8] and the judicial decisions defining words not defined by the proxy rules. The term "proxy" is defined in Rule 14a-1(d) as including "every proxy,

penses incurred by a director or officer in the successful defense of a suit. *See* J. W. JENNINGS & H. MARSH, SECURITIES REGULATION 214-226 (1972). This reimbursement of expenses for the defense of complicated and costly litigation might deplete the existing assets of the company and reduce the liquidation value of the security. It is also possible, but a matter of speculation, that the prosecution and defense of such a suit might adversely effect the market value of the security. This would likely depend upon such factors as the position of the company at the time the suit was filed, whether the security was still being traded and its value at filing, and the extent and nature of publicity about the suit.

[5] 15 U.S.C. § 78n(a) (1970) [hereinafter "Section 14(a)"].

[6] Our discussion will be directed to the case for applying the proxy rules to a letter from a security holder soliciting funds to prosecute an action against a corporation, but the reader should be aware that the same results would apply to any circularizing done by the corporation attempting to stifle such an action.

[7] 15 U.S.C. §§ 78a-78hh (1970) [hereinafter "the Act"].

[8] 17 C.F.R. § 240.14a-1 (1971).

consent or authorization within the meaning of Section 14(a) of the Act. The consent or authorization may take the form of failure to object or dissent."[9]

Rule 14a-1(f)[10] defines "solicit" and "solicitation" to mean as follows:

> (i) any request for a proxy whether or not accompanied by or included in a form of proxy; (ii) any request to execute or not to execute, or to revoke, a proxy; or (iii) the furnishing of a form of proxy or other communication to security holders under circumstances reasonably calculated to result in the procurement, withholding, or revocation of a proxy.

The terms "consent" and "authorization" are not defined in the proxy rules, but judicial decisions have adopted the definitions in Webster's Third International Dictionary which states that an "authorization" is a "grant or endowment of authority,"[11] and "consent" means "compliance [with] or approval . . . of what is done or proposed by another. . . ."[12] These expansive definitions can be interpreted to include any solicitation for a "grant of authority" or "approval" "in respect of any [registered] security."[13]

The argument for finding that letters soliciting funds for class actions are within the definitions here cited is that by soliciting funds for the prosecution of a suit, the security holder is actually soliciting "consents" or "authorizations" to represent other security holders in a suit "in respect of . . . a [registered] security." While such a characterization of the letters stretches the statutory language, this position appears tenable based upon the statutory purpose embodied in the Act and the expansive language employed by the judiciary in applying the statute. However, before reviewing the legislative history of the Act, an examination of the courts' standards for statutory interpretation of the Securities Acts is necessary. The Supreme Court set forth guidelines in *SEC v. C.M. Joiner Leasing Co.*,[14] summarizing its position when it interpreted the definition of "security" under the Securities Act of 1933[15] with the following language:

> [C]ourts will construe the details of an act in conformity with its dominating general purpose, will read text in light of context and will interpret the text so far as the meaning of the words fairly permits so as to carry out in particular cases the generally expressed legislative policy.[16]

The Court, discussing strict as compared to liberal construction of statutes,

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[9] 17 C.F.R. § 240.14a-1(d) (1971).

[10] 17 C.F.R. § 240.14a-1(f) (1971).

[11] *See, e.g.*, Greater Iowa Corp. v. McLendon, 378 F.2d 783 (8th Cir. 1967).

[12] *See, e.g.*, Dunning v. Rafton, [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,660 (N.D. Cal. 1965).

[13] 15 U.S.C. § 78n(a) (1970).

[14] 320 U.S. 344 (1943).

[15] 15 U.S.C. §§ 77a-77aa (1970).

[16] 320 U.S. 344, 350-51 (1943) (footnote omitted).

concluded further that, although a penal statute should be strictly construed, it should not be so strictly construed "as to narrow the words of the statute to [exclude] . . . cases which those words, in their ordinary acceptation, or in the sense in which the legislature has obviously used them, would comprehend."[17] It is, therefore, within this context of statutory interpretation that the legislative history of the Act and the judicial opinions interpreting § 14(a) should be read.

II. CHARACTERIZATION AS AUTHORIZATION

A. *The Purpose of the Act*

As noted above, the paramount concern of the Congress in adopting the Act was the protection of the public and the investor. A recognition of the dependent position of the investor, apparent in the House Report,[18] underscores the necessity for such protection. Congress' acknowledgement that the security holder must "have adequate knowledge as to the manner in which his interests are being served" and that it is "essential that he be enlightened not only as to the financial condition of the corporation, but also as to the major questions of policy, which are decided at stockholders' meetings,"[19] emphasizes the need for disclosure to investors of information relevant to their investment decisions.[20]

That Congress sought to protect the investor and adopted legislation requiring full disclosure in order to advance that protection is obvious. Moreover, it is submitted that the decision to leave the regulation of proxy solicitations to the Commission implies a recognition that continued flexibility is required to achieve the desired objectives.

There is, unfortunately, no discussion in the reports as to the meaning or scope of "consent" or "authorization." At least one early article suggests, however, that the terms were "intended to encompass situations such as solicitations in reorganization proceedings . . . to obtain authority to

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[17] *Id.* at 354. Although the court in *Joiner* was construing § 2(1) of the Securities Act of 1933 the same rules of statutory interpretation should apply to the '34 Act since the two acts are *in pari materia.*

[18] As a complex society so diffuses and differentiates the financial interest of the ordinary citizen that he has to trust others and cannot personally watch the managers of all his interests as one horse trader watches another, it becomes a condition of the very stability of that society that its rules of law and of business practice recognize and protect that ordinary citizen's dependent position. Unless constant extension of the legal conception of a fiduciary relationship—a guarantee of "straight shooting"—supports the constant extension of mutual confidence which is the foundation of a maturing and complicated economic system, easy liquidity of the resources in which wealth is invested is a danger rather than a prop to the stability of that system. When everything everyone owns can be sold at once, there must be confidence not to sell. Just in proportion as it becomes more liquid and complicated, an economic system must become more moderate, more honest, and more justifiably self-trusting.
H. R. REP. NO. 1383, 73d Cong., 2d Sess., 5 (1934).

[19] S. REP. NO. 792, 73d Cong., 2d Sess., 12 (1934).

[20] *See* H.R. REP. NO. 1383, 73d Cong., 2d Sess. (1934).

represent the security holder. . . ."[21] Agreeing with these authors, it is submitted that the act was passed to insure the dissemination of adequate information to security holders "in all those situations in which either the corporate management or outside groups bargained with security holders to affect the latter's rights."[22]

B. *Interpretations of the Range of Solicitations Subject to the Proxy Rules.*

While there has been surprisingly little litigation involving the definition of the word "proxy," cases have held that solicitations other than direct solicitations of votes in corporate elections are within the meaning of the term "proxy" and, therefore, subject to the rules. A review of these cases reveals the presence of two related but still distinct questions: first, the decision as to whether or not the communication at issue is, in fact, a solicitation; second, the determination as to whether the sender actually seeks a proxy, consent or authorization. This distinction is made because a careful reading of the cases indicates that the judiciary has not considered the actual breadth of "consent or authorization" in § 14(a).

Beginning with Judge Learned Hand's opinion in *SEC v. Okin*,[23] emphasis has been placed upon "solicitation" rather than "consent" or "authorization." In *Okin*, Judge Hand declared that it "would be going too far"[24] to say that Okin's letter to shareholders asking them not to sign any proxies for the company was a solicitation of a proxy, consent, power of attorney, or authorization.[25] He went on, however, noting the defendant's intention to follow up the letter with an actual solicitation of proxies, to hold that the proxy rules applied to "any . . . writings which are part of a continuous plan ending in solicitation and which prepare the way for its success."[26] The assumption which is implicit in the *Okin* opinion is that the terms "consent" and "authorization" are limited by the term "proxy" to the traditional context of proxy use. While Judge Hand's approach has been utilized by other courts[27] and the SEC has changed its proxy rules to conform to the decision,[28] it is suggested that *Okin* should not be taken as a limit on the scope of § 14(a).

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[21] Bernstein & Fisher, *The Regulation of the Solicitation of Proxies: Some Reflections on Corporate Democracy*, 7 U. CHI. L. REV. 226, 231 (1940).

[22] *Id.*

[23] 132 F.2d 784 (2d Cir. 1943).

[24] *Id.* at 786.

[25] The *Okin* decision involves Section 12(e) of the Public Utility Holding Company Act, 15 U.S.C. § 79*l*(e) (1970), which is substantially similar to Section 14(a). *See* part II(C), *infra*, for a more detailed comparison.

[26] 132 F.2d at 786.

[27] *See, e.g.*, SEC v. Topping, 85 F. Supp. 63 (S.D.N.Y. 1949).

[28] *See* Securities Exchange Act of 1934 Release No. 5276, Jan 17, 1956, *and* E. ARANOW & H. EINHORN, PROXY CONTESTS FOR CORPORATE CONTROL 87-92 (1957).

In *Dunning v. Rafton*[29] the court ruled that letters sent by the defendants urging certificate holders of a voting trust to terminate the trust were solicitations for a "consent" within § 14(a).[30] The court stated that it "did not consider the meaning of the word 'consent' in the Act to be limited by the more specific term 'proxy' preceding it,"[31] and then went on to state that "the solicitation of consents would, according to common usage, include any circularizations requesting or urging a security holder to concur in or go along with the solicitor's proposals."[32]

In *Greater Iowa Corp. v. McLendon*[33] the court, after characterizing the purpose of § 14(a) as "providing full and honest disclosure by those who are seeking to maintain or gain control of a corporation through solicitation of the corporate voting rights of shareholders,"[34] ruled that the defendant's solicitations for memberships in a voting trust were solicitations for "authorizations" under § 14(a). However, the court in no way limited its definition of "authorization," recognizing it as "the grant or endowment with authority."[35] Moreover, the court before accepting this dictionary definition commented on the intended breadth of § 14(a):

> While "proxy" is perhaps a narrow word of art implying an agency relationship, the statute goes further. The words "consent" and "authorization" are extremely broad words and are not limited by the word "proxy." No doubt Congress intended that the words of the Act be given the broadest meaning necessary to effectuate its stated purposes. . . . By including all of these words in the disjunctive, we believe Congress intended to cover the entire field of solicitation for corporate control and all of the various solicitation situations which might arise from time to time whether conventional, novel, irregular or unorthodox.[36]

Finally in *Studebaker Corp. v. Gittlin*[37] the court ruled that a stockholder's solicitations for authorizations to obtain inspection of the corpo-

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[29] CCH FED. SEC. L. REP. ¶ 91,660 (N.D. Cal. 1965) [1964-1966 Transfer Binder].

[30] *Id.* at p. 95,437.

[31] *Id.*

[32] *Id.* This expansive interpretation of "consent" in *Dunning* is limited somewhat by the literal language used by the court in discussing the purpose of the Act. The court cited SEC v. May, 229 F.2d 123 (2d Cir. 1956) and concurred that the Act was promulgated "to protect the investing public from misleading statements made in the course of a struggle for corporate control."

[33] 378 F.2d 783 (8th Cir. 1967).

[34] *Id.* at 795.

[35] *Id.* at 796.

[36] *Id.* The *Greater Iowa* court limited its opinion by saying that the statute should be interpreted as encompassing solicitations for membership in voting trusts in some circumstances and that each case must be decided on an *ad hoc* basis. The court emphasized the defendant's intent to secure corporate control and the literal language of the legislative history to conclude that the statute should apply. The similarities between a proxy and membership in a voting trust made such a conclusion a practical necessity if Section 14(a) were to retain any vitality.

[37] 360 F.2d 692 (2d Cir. 1966).

ration's stockholders list[38] were subject to § 14(a) and the proxy rules. Judge Friendly stated:

> The statute is worded about as broadly as possible, forbidding any person "to solicit any proxy or consent or authorization" in respect of any security therein specified "in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors"; the definitions in Proxy Rules, 14a-1, exhaust the sweep of power thus conferred.[39]

This statement is dicta, however, since the court did not find it necessary to go so far as to allow the injunction in the case presented to it. The solicitations before the court were by a single shareholder requesting authorization in a New York state court proceeding to obtain an inspection of the shareholders list. The court was therefore able to rely on the more conservative theory expressed in *SEC v. Okin*,[40] discussed above. Although the precise holding by the court was that the defendant's letter was subject to the proxy rules because it was a part of a continuous plan intended to end in solicitation of votes at a stockholders' meeting, the expansive language quoted above was buttressed by a letter from the SEC which related the Commission's view regarding the proper breadth of the definition of "authorization":

> Section 14(a) of the Securities Exchange Act of 1934 and the Commission's rules thereunder apply to any proxy, consent, [or] authorization and are not limited to proxies, consents and authorizations in situations involving elections to office. There is no reason to suppose that Congress intended that the protective provision of the proxy rules should not reach other situations in which a stockholder is requested to permit another to act for him, whatever may be the purpose of the authorization.[41]

The failure (refusal) of the *Gittlin* court to consider directly the SEC's expansive interpretation of the proxy rules has led one commentator to assert that the practical effect will be to affirm the SEC position.[42] The validity of this prediction must await determination until more courts are confronted with the necessity of construing the statutory language in ques-

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[38] It was necessary for Gittlin to secure authorization from an aggregate of five percent of the corporation stock to comply with New York law:

> Any resident of this state who shall have been a shareholder of record . . . or any resident . . . holding, or thereunto authorized in writing by the holders of, at least five percent of any class of the outstanding shares, . . . may require such foreign corporation to produce a record of its shareholders. . . .

N.Y. Bus. Corp. Law § 1315(a) (McKinney 1963).

[39] 360 F.2d at 695.

[40] 132 F.2d 784 (2d Cir. 1943).

[41] SEC v. Gittlin, 360 F.2d 692, 695 n.2 (2d Cir. 1966). For other indications that the commission favors this position see H. FLOM, H. GARFINKEL & J. FREUND, DISCLOSURE REQUIREMENTS OF PUBLIC COMPANIES AND INSIDERS 82 (1967) and 4 L. LOSS, SECURITIES REGULATION 2841 (2d ed. Supp. 1966).

[42] 65 MICH. L. REV. 582, 589 (1967).

tion. In any event it is clear that, to date, the cases have uniformly involved solicitations that either:

1) have as their goal the direct solicitation of votes,[43] or
2) have as their goal the kind of authorization which controls or influences the votes of the security holders.[44]

The precise holdings of these cases are consistent with a narrow reading of the statutory language and a limited view of the legislative history. However, the language employed by the courts in deciding these cases has been much more expansive and, taken with the Act's general purpose of protecting the investing public, supports the application of § 14(a) to a solicitation in a class action.

C. *Halsted v. SEC*[45]

In *Halsted*, the defendant attempted to circularize stockholders of the Long Island Lighting Company, a company in reorganization, to obtain contributions to the fees and expenses of a shareholders' protection committee. The court there held that requests for such contributions were solicitations for "authorizations" within the meaning of § 12(e) of the Public Utilities Holding Company Act of 1935.[46] After reviewing the statutory provisions and their history, the court stated:

> In the light of these provisions and their history, we think the Commission was correct in finding that the proposed action in circularizing stockholders amounted to soliciting an "authorization" within the meaning of Section 12(e), and that it would or could produce "circumvention of the provisions of this chapter or the rules, regulations, or orders thereunder" within the meaning of the same section. To construe the provisions of Section 12(e) as covering only the solicitation of "any proxy, power of attorney, consent, or authorization" in *haec verba* would defeat the patent congressional intent to give the Securities and Exchange Commission a needed measure of control over the relationships between the stockholders and the persons who seek to represent them in reorganization proceedings. . . . It cannot be questioned that a contribution of funds could well make any prior right of representation more potent and effective. But more important, from the standpoint of investor protection, is

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[43] *See, e.g.*, Studebaker Corp. v. Gittlin, 360 F.2d 692 (2d Cir. 1966).

[44] *See, e.g.*, Greater Iowa Corp. v. McLendon, 378 F.2d 783 (8th Cir. 1967).

[45] 182 F.2d 660 (D.C. Cir. 1950).

[46] 15 U.S.C. § 79l(e) (1970). The language of Section 12(e), which is very similar to the language of Section 14(a) of the 1934 Act, states:

> It shall be unlawful for any person to solicit or to permit the use of his or its name to solicit, by use of the mails or any means or instrumentality of interstate commerce, or otherwise, any proxy, power of attorney, consent, or authorization regarding any security of a registered holding company or a subsidiary company thereof in contravention of such rules and regulations or orders as the Commission deems necessary or appropriate in the public interest or for the protection of investors or consumers or to prevent the circumvention of the provisions of this chapter or the rules, regulations, or orders thereunder.

> the fact that it binds the shareholder to the committee to which he has contributed. . . .[47]

The analogy between *Halsted* and a solicitation for funds in a class action is clear and *Halsted* should be persuasive authority for the proposition that a solicitation letter of this nature is subject to the proxy rules under § 14(a). There are, however, dissimilarities which cannot be overlooked in relying on the reasoning in *Halsted*. The language in § 12(e) of the 1935 Act[48] is somewhat more expansive than that in § 14(a) and the court, in *Halsted*, was relying in part on that more expansive language to reach its conclusion. Section 12(e), as cited above, includes the language:

> [I]t shall be unlawful for any person to solicit . . . any . . . authorization . . . in contravention of such rules . . . as the Commission deems necessary . . . to prevent the circumvention of the provisions of this chapter or the rules, regulations, or orders thereunder.

To allow the solicitation of funds in this case would have been to allow circumvention of § 11(f) of the 1935 Act[49] which gave the Commission control over the fees of a stockholders' protection committee. This element, of course, distinguishes *Halsted* from the hypothetical case.

In dicta, the court also stated that the Commission's control over "the proxies" under the '35 Act was more extensive than under the '34 Act.

> The Securities and Exchange Commission had previously, in the Securities Exchange Act of 1934 . . . been given power to supervise communications addressed to holders of securities registered under that Act where proxies or similar authorizations were being solicited. . . . In the Public Utilities Holding Company Act of 1935, passed a year later, the Congress gave the Commission broader powers over proxy solicitations than it had been given in the 1934 Act.[50]

This explanation by the court in *Halsted* conflicts with the expansive language found in dicta in the decisions cited above,[51] but does not, however, conflict with the direct holding of these cases. As a result, the application of *Halsted* to the hypothetical situation herein must be with some circumspection.

D. *Federal Civil Rule 23*

Amended Federal Civil Rule 23[52] provides that when the statutory

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[47] Halsted v. SEC, 182 F.2d 660, 664 (D.C. Cir. 1950).

[48] 15 U.S.C. § 79*l*(e) (1970).

[49] 15 U.S.C. § 79k(f) (1970).

[50] 182 F.2d 660, 662 (D.C. Cir. 1950). A comparison of the language of these sections would so indicate; however, the legislative history of the '35 Act does not indicate that Congress had this specific intention. *See* H.R. REP. NO. 1318, 74th Cong., 1st Sess., 18 (1935) *and* S. REP. NO. 621, 74th Cong., 1st Sess., 35 (1935).

[51] *See* part II(B) *supra.*

[52] FED. R. CIV. P. 23.

conditions are met, "[o]ne or more members of a class may sue or be sued as representative parties on behalf of all . . . ." None of the conditions requires the representative to obtain authorizations from other members of the class.[53]

The characterization of this solicitation letter as an authorization may, therefore, be less tenable than in similar situations, (*e.g.*, the solicitation of funds to prosecute a derivative suit) because in this case, as indicated by the above cited rules, the security holder who is presently soliciting funds may not need the authorizations to act in behalf of other securities holders. Since the members of the class are determined by law, requests for authorizations are unnecessary, thus the characterization of the letter as a solicitation becomes less likely. This difficulty is arguably overcome, however, if one considers such a case in its early stages, prior to a determination by the court, under Rule 23(c)(1)[54] as to whether the action is to be maintained as a class action.[55] At this point in the litigation two arguments militate for the conclusion that the letter is a solicitation for authorizations. (1) If the court were to determine that the action could not be maintained as a class action, contributions received as a result of the solicitation letter could be used to isolate those people who were sympathetic to the action and who could be represented on an individual basis.[56] (2) If the court were to determine that the action could be maintained as a class action, the representations made in the solicitation letter could have a material affect on the security holder's decision to "opt out" under Rule 23(c)(2).[57] As such the letter can be viewed as a solicitation for authority to represent the security holders' interest.[58]

Moreover, when letters are sent prior to the filing of an actual suit, the argument for such characterization becomes more compelling. Prior

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[53] FED. R. CIV. P. 23(c)(1), (2):

(1) As soon as practicable after the commencement of an action brought as a class action, the court shall determine by order whether it is to be so maintained. An order under this subdivision may be conditional, and may be altered or amended before the decision on the merits. (2) In any class action maintained under subdivision (b)(3), the court shall direct to the members of the class the best notice practicable under the circumstances, including individual notice to all members who can be identified through reasonable effort. The notice shall advise each member that (A) the court will exclude him from the class if he so requests by a specific date; (B) the judgment, whether favorable or not, will include all members who do not request exclusion; and (C) any member who does not request exclusion may, if he desires, enter an appearance through his counsel.

[54] FED. R. CIV. P. 23(c)(1).

[55] In at least one case this determination was deferred for three years. *See* Block, *Class and Derivative Actions Under the Securities Laws*, 26 BUS. LAW. 425, 432 (1970).

[56] *Cf.* SEC v. Okin, 132 F.2d 784 (2d Cir. 1943).

[57] FED. R. CIV. P. 23(c)(2).

[58] *See* Halsted v. SEC, 182 F.2d 660, 664 (D.C. Cir. 1950): "It cannot be questioned that a contribution of funds could well make any prior right of representation more potent and effective. But more important . . . is the fact that it binds the shareholder to the committee to which he has contributed."

to filing there is no possibility for court supervision of the solicitations as exists under the federal rules after filing.[59] The need for regulation of solicitations prior to judicial supervision under Rule 23 is implicit in the American Law Institute's First Tentative Draft of the Federal Securities Code.[60] This draft suggests a prohibition on proxy solicitation substantially like that of § 14(a). Besides, in listing the drafters' suggestions to exemptions from the proxy rules the Code states:

> (i) . . . Section 602(b) to (h) inclusive [the prohibition against solicitation] does not apply with respect to a solicitation or circularization.
> . . . .
> (8) of security holders in a class or stockholders' derivative action *if the solicitation or circularization is under judicial supervision pursuant to a Federal or State statute or rule. . . .*[61]

The inclusion of this exemption by the drafters of the model code is indicative of the acknowledgement on their part that existing proxy regulations currently apply to solicitations by any groups which "bargain with security holders to affect . . . [their] rights."[62] The exemption takes account of the fact that in a class action, once judicial supervision does attach, the courts have discretion to control the action.[63] However, implicit in the language chosen is the recognition that prior to the attachment of judicial supervision, the proxy rules should apply to any solicitations in class actions or derivative suits.

III. REMEDIES AND STANDING

A. *Remedies*

Throughout this article it has been assumed that the court would be able to give relief by granting an injunction against further solicitations and against the use of money obtained through solicitation in violation of the proxy rules. It is now well settled that the courts have authority to grant plastic remedies in cases of securities acts violations, to do whatever is necessary to redress the damage proven.[64] In a case such as this there is little doubt that if it were established that solicitation letters are subject

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[59] *See* FED. R. CIV. P. 23(d).

[60] A.L.I., FEDERAL SECURITIES CODE (Tent. Draft No. 1, 1972).

[61] A.L.I., FEDERAL SECURITIES CODE § 602(i) (Tent. Draft No. 1, 1972) (emphasis added).

[62] Bernstein & Fisher, *The Regulation of the Solicitation of Proxies: Some Reflections on Corporate Democracy*, 7 U. CHI. L. REV. 226, 231 (1940).

[63] *See* FED. R. CIV. P. 23(d).

[64] *See, e.g.*, Greater Iowa Corp. v. McLendon, 378 F.2d 783, 790 (8th Cir. 1967): "And in Bell v. Hood, 327 U.S. 678, 684 . . . (1946) the court reiterated 'And it is also well settled that where legal rights have been invaded, and a federal statute provides for a general right to sue for such an invasion, federal courts may use any available remedy to make good the wrong done'. . . ."

to the proxy rules and that the movant has standing to complain of the violation, injunction is a proper remedy.

B. *Standing*

The SEC of course has standing to enforce the proxy rules[65] and no discussion of this point is necessary. It may be, however, that tactical considerations would suggest the assertion of proxy violations by a party other than the SEC. At least two other possibilities exist: 1) A security holder who received the solicitation letter; and 2) the corporation.

1. The Security Holder.

A security holder who received the solicitation and who was a defendant would be most likely to have standing to move for an injunction. Two theories support this conclusion: first, there is a public interest in the enforcement of the proxy rules, and second, this class of person can demonstrate a potential injury to his interest. Such a defendant need not be deceived by the solicitation to seek an injunction. The court, in *Dann v. Studebaker-Packard Corp.*[66] stated that:

> These appellants do not specifically allege that they themselves were misled by the appellees or that they gave appellees any proxies at all. As we have noted above, the right sought to be protected by federal law is the right of full and fair disclosure in corporate elections. . . . They could suffer equally damaging injury to their corporate interests merely because other shareholders were deceived in violation of federal law. Accordingly, they should be entitled to protect themselves against such violations to the same extent as if they, themselves, were the direct victims of the unlawful deception. We are in an agreement with Professor Loss, of the Harvard Law School, who . . . said: "This question of standing has received only the scantiest attention in the cases. . . . In principle it is difficult to see why there should be any limitation on this sort of private action under Section 14(a). The remedy is based . . . on the premise that either side in a contested solicitation has a legitimate interest, in view of the statutory purpose, to cry "foul" against the other. . . ."[67]

The *Dann* case is admittedly distinguishable from the instant case in that it involves an action for violation of the proxy rules in a solicitation for proxies to be used in a corporate election. At that election, there was approved an "arrangement" between the defendant corporation and Curtiss-Wright Corporation which resulted in a "waste and dissipation" of Studebaker-Packard assets. Therefore, as noted above, the complainants "suffered equally damaging injury to their corporate interest because others were deceived in violation of federal law," and the value of their

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[65] 15 U.S.C. § 78u (1970).

[66] 288 F.2d 201 (6th Cir. 1961).

[67] *Id.* at 209.

stockholdings fell because the arrangement described above had been approved at the corporate election.

The same argument is, however, equally applicable in this hypothetical case. As a security holder in the company, one has an interest in its reorganization or in the liquidation of its assets. The funding of a class action may have a deleterious affect on that interest because the company may be required to reimburse many of the defendants for expenses incurred in the defense of that action; the remaining interest of the security holders will therefore be substantially less.[68] Such damage should be sufficient to cause the court to grant the relief sought because of the added public interest factor in the enforcement of the proxy rules. Judge Friendly stated as much in *Studebaker Corp. v. Gittlin*[69] when he said:

> A plaintiff asking an injunction because of the defendant's violation of a statute is not required to show that otherwise rigor mortis will set in forthwith; all that "irreparable injury" means in this context is that unless an injunction is granted the plaintiff will suffer harm which cannot be repaired.[70] At least that is enough where, as here, the only consequence of an injunction is that the defendant must effect a compliance with the statute which he ought to have done before. To be sure, time is of the essence in proxy contests—at least the participants generally think it to be. But the district court could properly have considered that the public interest in enforcing the proxy rules outweighed any inconvenience to Gittlin in having to start again. In this aspect decision rested in the judge's sound discretion; we find no abuse.[71]

Certainly, the security holder who received the solicitation letter is within the class of persons intended to be protected by these rules, since it was he the solicitor was attempting to influence.

2. The Corporation.

Once the private right of action in securities regulation is recognized,[72] the conclusion that the corporation should also be able to bring an action on its own behalf is apparent.[73] Just as a stockholder is damaged by the necessity of defending a frivolous class action, so too is the corporation as a whole. It is well established that the corporation possesses a ju-

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[68] *See* note 4 *supra.*

[69] 360 F.2d 692 (2d cir. 1966).

[70] It would seem that this is all "irreparable injury" ever means, but in this context it is apparent that Judge Friendly intended to hold the plaintiff to a lower standard than is usually applicable when an injunction is sought.

[71] 360 F.2d 692, 698 (2d Cir. 1966).

[72] J. I. Case Co. v. Borak, 377 U.S. 426 (1964); Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946).

[73] *See* SEC v. Gittlin, 360 F.2d 692 (2d Cir. 1966).

ridical personality and to find against corporate standing would be wholly illogical.[74]

IV. CONCLUSIONS

There is no doubt that the characterization of a letter soliciting funds for the prosecution of a class action suit as the soliciting of an "authorization" under § 14(a) of the Act is a close question. Certainly there is no authority directly in point and the narrow holdings of the cases which have constructed § 14(a) would not corroborate the conclusion. As the above discussion has indicated, however, the language chosen by these courts sustains the characterization. Moreover, focus on the "dominating general purpose"[75] of the Act also bolsters the suggested result. Obviously in order for a court to hold such a solicitation to be within § 14(a), it must resolve to underscore the broad intentions of the Act and employ an expansive interpretation of the statute.

It is submitted that such a ruling is consistent with the authority cited herein. The resolution of this question narrows to a choice between the continued utilization of § 14(a) in only those situations in which solicitations were clearly directed to effecting "corporate action,"[76] and the use of the proxy rules whenever security holders are circularized with regard to any rights relating to such securities. When one recognizes the increasing complexity of security ownership and the expanding ownership of securities, the latter direction is compelled. The enactors of the existing securities laws recognized the essential need of protecting the investor but could not conceivably allow for every potential abuse with explicit language.

The class action device as it is now constituted in Rule 23[77] is a useful tool in securities regulation acknowledged as having a "therapeutic value" in this field.[78] The amended rule has gone a long way toward removing the potential for abuse inherent in class actions.[79] However, there remains an area in which this potential still exists.[80] It is most reasonable that any

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[74] *See* 42 N. DAME LAW. 84 (1965) for a discussion of the development of standing for the corporation.

[75] SEC v. C. M. Joiner Leasing Corp., 320 U.S. 344, 350 (1943).

[76] *See* Hoover v. Allen, 241 F. Supp. 213, 230 (S.D.N.Y. 1965): "In the absence of some allegation of infringement upon corporate suffrage rights or some corporate action taken as a result of such infringement no cause of action under Section 14(a) has been made out."

[77] FED. R. CIV. P. 23.

[78] *See* Dolgow v. Anderson, 43 F.R.D. 472, 485 (E.D.N.Y. 1968).

[79] *Id.* at 486-87.

[80] This potential for abuse has been recognized by the Judicial Panel on Multidistrict Litigation:

> The class action under Rule 23 is subject to abuse, intentional and inadvertent, unless procedures are devised and employed to anticipate abuse. Among the potential abuses of the class action processes are the following: (1) solicitation of direct legal representation of potential and actual class members who are not formal parties to

security holder asked to contribute to the prosecution of a class action should be adequately informed with regard to the suit. Not only are his interests involved insofar as he contributes his funds to the action, but the value of his securities may be affected by such a suit.

Application of the proxy rules to such a solicitation will accomplish at least two things without imposing a substantial burden on the solicitor. First, such a requirement should go far to insure that any communications to security holders meet the requirements of full disclosure, and second, such a requirement should substantially aid the courts in controlling these actions once judicial supervision attaches. The notice requirements of Rule 23, aimed at due process concerns[81] rather than investor information, make no certain contribution to investor knowledge. Imposing proxy rules upon these solicitations and thus insuring that investors are informed will serve as a significant hurdle to the filing of frivolous law suits, but will not impede the use of the class action for meritorious claims. Moreover, it is important to recognize that the application of proxy rules to these solicitations would also lead to the same application to any company communications attempting to dissuade investors from the action, thus ensuring full disclosure of information on both sides. Such a liberal recognition of the SEC's power aids in the fulfillment of the regulatory purposes by giving the SEC the necessary control over the relationship between stockholders and those desiring to represent them.[82]

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the class action; (2) solicitation of funds and agreements to pay fees and expenses from potential and actual class members who are not formal parties to the class action; (3) solicitation by formal parties of requests by class members to opt out in class actions under subparagraph (b)(3) of Rule 23; and (4) unauthorized direct or indirect communications from counsel or a party, which may misrepresent the status, purposes and effects of the action and of Court orders therein, may confuse actual and potential class members, and create impressions which may reflect adversely on the Court or the administration of justice. To anticipate and prevent these abuses timely action should be taken by local rule or by orders in the particular civil action or by both.

In absence of some preventive action by the Court, formal parties to the action or counsel for the formal parties may directly or indirectly, without knowledge or consent of the Court, solicit from the potential or actual members of the class (or subclasses) who are not formal parties, funds for attorneys' fees and expenses, or agreements to pay fees and expenses. The solicitation may be direct or indirect. To the party solicited, solicitation may appear to be an authorized activity approved by the Court, simply by reference to the title of the Court, the style of the action, the name of the judge, and to official processes. Such unapproved solicitation may be of doubtful ethical propriety and may result in well founded disatisfaction with the judicial management of the action.

MANUAL FOR COMPLEX AND MULTIDISTRICT LITIGATION 48 (as revised May 18, 1970).

[81] *See* Comment, Adequate Presentation, Notice and the New Class Action Rule: Effectuating Remedies Provided by the Securities Laws, 116 U. PA. L. REV. 889, 907-08 (1968).

[82] 42 N. DAME LAW. 84 (1965).